Economics and Sociology
Occasional Paper No. 1494

COSTA RICA
POLICY TOOLS FOR RURAL FINANCE

COSTA RICA:
THE PRIVATE COMMERCIAL BANKS AND THE AGRICULTURAL SECTOR

by

Douglas H. Graham

Rural Finance Program
The Ohio State University
and
Academia de Centroamérica

September, 1988

COSTA RICA: THE PRIVATE COMMERCIAL BANKS AND THE AGRICULTURAL SECTOR

Douglas H. Graham*

During July, 1988, visits to six private commercial banks were undertaken, in order to gather first impressions on the role of these banks in servicing an agricultural portfolio and to explore the likelihood of any future changes that could lead to increased attention to a rural clientele. COFISA, INTERFIN, Banco de San José, Banco de Fomento Agrícola, BANEX, and BCT comprised the list of banks visited. In addition, officials from BANCOOP and FEDECREDITO were interviewed. However, the latter two intermediaries will be the subject of a separate report.[1/] The comments that follow are impressionistic and are not intended to be supported by any extensive documentation. Additional quantitative analysis of the agricultural lending activities of these banks could be undertaken in future visits. The present report merely highlights major issues and the concerns expressed by a selected number of private commercial bank officials with respect to their role in servicing an agricultural portfolio.

The report is divided into four sections. The first part clarifies the nature of the agricultural activities currently serviced by the sample of private banks. The second section summarizes the principal constraints faced by these banks in attempting to expand their agricultural portfolio. The third section identifies potential institutional innovations in order to expand this portfolio. The final section addresses some broader issues that USAID and the GOCR may have to face in trying to expand the role of the private commercial banks in agricultural lending.

I. PROFILE OF AGRICULTURAL ACTIVITIES

Most of the private commercial banks visited reported some agricultural loans. COFISA indicated that close to one-half of their portfolio is devoted to agriculture. BANEX follows close behind. For most of these banks the share of agriculture falls in the 10 to 20 percent range. The crop lines financed are almost all in the non-traditional export area and cover a wide range of tropical fruits such as mangos, pineapples, melons, and strawberries, along with African palm, poultry, root crops like yuca, nuts like macadamia, and specialty foods like palmito (hearts of palm). In addition, wood products, coffee, cacao, and banana activities as well as the rapidly growing field of cut flowers and ornamental plants are funded. In some cases the financing is for the agro-processor or the agro-exporter; in other cases it is directly for the producers. More detailed analysis is needed to separate the number and amount of loans that go to farmers as compared to value-added activities (users of agricultural raw materials).

Many of the borrowers, who have businesses other than the one being financed, were already bank clients in their other connections. Collateral is generally available as well as information on business background and experience relevant for the project being financed. Thus the private commercial banks are able to evaluate and manage risk in their agricultural portfolio, something that the state-owned banks are frequently unable to do when they manage their portfolios of loans for traditional (particularly non-export) agriculture. Not surprisingly, the private commercial banks avoid the traditional portfolio of cattle and basic-grains loans.

All banks claim that from one-third to one-half of their present customers had been clients of the state-owned banks in earlier years. This suggests that the growth of the non-traditional agricultural portfolio in the private commercial banks has come not only through new clients, beginning their business for the first time (but frequently with businesses in other areas), but also through portfolio transfers from the state-owned banks. This element of market competition exists for the non-agricultural portfolio as well. Indeed, the private commercial banks have captured about one-half of the market share for industrial loans. This raises the question of whether these shifts will lead to a healthy competitive restructuring within the state-owned banks or to their collapse into servicing only the less attractive and riskier traditional clientele.

II. CONSTRAINTS TO PORTFOLIO EXPANSION IN AGRICULTURE

(1) The major constraint to expanding the portfolio of loans to agriculture lies in the high cost of funds for the private banks. Six-months certificates of deposit and related instruments must pay between 22 to 26 percent per year. Since the private banks are prohibited from mobilizing checking accounts (at zero interest) and low-cost passbook savings accounts, they must lend out their more expensively-sourced funds. This results in much higher loan rates than those charged by the state-owned banks. Moreover, the private banks must keep 10 percent of their liabilities as reserves (encaje legal) and an additional 20 to 25 percent for contingency reserves (to replace the absence of last-resort rediscount facilities, since only the state-owned banks have access to the Central Bank). This leaves 70 to 75 percent of their mobilized funds available to loan out in order to earn interest. To cover these financial costs and break even, these banks would have to charge between 29 and 35 percent on their loans. Even with small operational margins, these rates severely limit their competitiveness, particularly in view of subsidized state-owned bank credit for many agricultural activities. Only non-traditional agricultural enterprises with profitable overseas markets are able to pay these rates. Traditional agricultural activities are unable to earn a sufficient rate of return to bear this interest cost. This explains why the private commercial banks have used mostly donor funds, obtained a lower financial cost, for their agricultural lending.

(2) Another factor adding to the cost of funds is the continuing crowding out of the private sector by the public sector in its issuance of government bonds, in order to cover the fiscal deficit. The market pressure that results from the expanding issue of public-sector paper creates an upward pressure on interest rates.

(3) Additional constraints are associated with the borrowers' economic condition. Too rapid a growth of the non-traditional agricultural portfolio quickly reaches the limits of the productive or entrepreneurial capacity available in this area. At the same time, international marketing networks are difficult and costly to arrange in a quick and secure fashion. Expertise and technological know-how for these new ventures are also in limited supply. Frequently, these firms are over-leveraged, with little collateral or debt capacity left to use for private-bank financing.

(4) The long-term nature of much of this portfolio (especially for macadamia, cacao, fruits) requires loan maturities from 5 to 8 years. This does not match the much shorter term structure of the banks' liabilities. Hence, the need to secure longer-term donor funding, in order to bring this match of asset and liability structures into closer balance.

(5) To date, special lines of credit through the short-term FOPEX rediscounting line or the longer-term FODEIN program have been used to access working and fixed-capital needs. Special USAID funds have been available for specific banks at various times in the past and have facilitated the expansion of the capital base of selected banks as well as their longer-term lending.

(6) An additional constraint to portfolio expansion in agriculture has been the lack of private-bank branches in the interior. Commercial bank branches are typically set up to capture current account deposits and passbook savings, which are relatively cheaper sources of funds. Depending on the circumstances, the funds so mobilized may be transferred, in part, for loan activity by other agencies, within a national network. The depositor-to-borrower ratio in any commercial bank is <u>at a minimum</u> a multiple of 20 to 1 and frequently higher. In short, deposit services are essential to make bank branching a profitable activity. Furthermore, continued promising deposit behavior for selected clients can be the lead into opening up loan activity for the same clientele. Without this previously established base of local depositors in the interior, it may be uneconomic to gather the necessary information to evaluate the creditworthiness of potential borrowers in that region.

Currently, all banking activity carried out with the present set of customers is handled through the banks' central offices or a few branches in the suburban city of San Jose. Until private commercial banks are given the right to mobilize current account deposits and passbook savings, branching will remain unprofitable.

(7) A final constraint to an expansion of the portfolio is the negative impact of the recent FODEA rescheduling measures for the traditional cattle producers and basic grains and other farmers. This action inculcated bad credit habits and created an added risk to any private bank that might have considered drawing into its portfolio an initial small number of traditional producers. Furthermore, FODEA created a misleading creditworthiness profile in the state-owned banks portfolio, thereby erasing past information on loan recovery records. This removal of potentially useful client-evaluation information added to the risks and costs of any bank that might deal with these clients in the future.

III. CURRENT AND POTENTIAL RISK MANAGEMENT METHODS TO SERVICE AN AGRICULTURAL PORTFOLIO

(1) With the private commercial banks facing more expensive sources of funding, their viability demands that they be very

cautious in allocating their loan funds. Collateral-based financing must dominate, unless an equivalent collateral substitute is used, in order to manage portfolio risk. Thus, it is not surprising to see these banks resorting to much cheaper donor sources of funds to package their loans to agriculture. The donor sources also allow for a lengthening of the term structure of funding for the clients.

(2) An additional means of managing risk is to finance the processors or agro-marketers. This funding gives these firms sufficient liquidity to guarantee crop purchases from the producers. In some instances, advances are made to the producers from these firms which, in turn, have received private-bank financing. In the end, a trickle-down chain of credit eventually reaches the relevant producers of the non-traditional export products. The fact that many of these firms also undertake collateral business activity adds to the collateral base and reduces risk for private bank financing.

(3) An interesting new approach is being considered by one of the banks interviewed. This would entail making loans directly to producers of non-traditional crop lines. The farmers would have been preselected by the agro-processor, packager, or exporter to whom they sell their crop. The farmer's land would be used as collateral. Thus, the major cost- and risk-reducing feature of lending would be carried out by the agrobusiness,

namely, the creditworthiness evaluation. The agrobusiness would also carry out on-site technical assistance for the farmers, in order to guarantee quality control, in view of the requirements of their international markets. They would also collect the loan payments for the private bank, through appropriate deductions from the purchase price of the crops. It would presumably be in the interests of the agrobusiness to see these suppliers of raw materials (i.e. the agricultural producers) adequately financed by the bank, in order to guarantee a quality product for the foreign market.

(4) Although it is extremely difficult to imagine significant private-bank branching occurring without the authorization to mobilize sight and passbook accounts, a donor-based strategy could possibly succeed if a project is designed to guarantee a critical minimum number of potential beneficiaries geographically concentrated in one area.

This possibility could justify the opening of a branch, in order to service loan collection more effectively than what can be done from the central office in San Jose. Of course, the private bank could also offer its limited line of deposit services and in time conceivably expand its lending to additional clientele. To gain the scale economies necessary to justify the opening of a branch (without the appropriate deposit instruments), targeting should be relaxed, in order to ensure a sufficiently large clientele.

(5) The promotion of a technical-assistance capacity, either within the private banks themselves or within private agrónomo consulting firms, is another institutional innovation that could reduce the risks inherent to ventures in non-traditional agricultural activity. Pilot projects promoting one and/or the other approach can be designed into future USAID agricultural loan projects.

IV. REMAINING ISSUES FOR DONORS AND THE GOCR

(1) Every private-bank manager with whom we talked appreciated the importance of expanding their agricultural portfolio, in order to broaden the base of political support for the legitimacy of private banks in Costa Rica. This also motivates them to make donations to the ACORDE-FINCA program, which promotes micro enterprises and community-participation efforts, such as the small bancos comunales (community banks). This suggests that some of the private commercial banks may be willing to participate in experiments that increase their capacity to serve the rural areas.

(2) When donor projects have been offered for non-traditional agricultural activities, a number of private commercial banks have responded quickly to the package of incentives available. An issue for the future is whether USAID would not be

better served by spreading its largess more widely among a larger number of private banks than has been characteristic in the past. This would broaden the range of institutions that serve agriculture, would create a more competitive base for future growth in the area, and would remove any image of discriminatory behavior.

(3) USAID and Central Bank (BCCR) discussions to explore joint efforts to promote private commercial bank branching opportunities could prove useful. While it may be possible for the Mission to launch a package of incentives to encourage limited branching efforts, the BCCR is the regulatory entity whose actions could influence this initiative positively or negatively. They should be a part of the discussion from the beginning.

(4) The BCCR should also review current operating rules and regulations concerning branch management performance, i.e. capital adequacy, liquidity, and client exposure ratios as well as conflict of interest rules associated with bank ownership and bank activity. Tighter rules could prevent future bank failures. This regulations should not be used, however, to further restrict entry into the market.

(5) The constant promotion of non-traditional agricultural exports may reach market absorption limits in the near future, especially for tropical fruits and root crops for the limited

ethnic markets in the United States. Also, the cut flowers and ornamental plants may face countervailing duties from the United States due to the export bonus scheme (the CATs) employed in Costa Rica to promote these exports. This can be considered to be a case of dumping by GATT rules.

(6) The impressive success of the private commercial banks in recent years has come partially at the expense of the state-owned bank portfolio. This could continue to such an extent that the private banks end up with all the good clientele, with relatively good rates of return (and who repay their loans responsibly), while the state-owned banks end up with an "adversely" selected portfolio, by default. Hopefully, this possibility will spur the state-owned banks to respond competively and to introduce more efficient portfolio-management techniques and a more efficient organization for capturing scale and scope economies. If this does not happen, and if the political authorities prevent the state-owned banks from becoming more efficient, then they could collapse into financial-welfare agencies and, in turn, cause a political backlash against the private banks. Therefore, all effort should be made to support the state-owned banks in their drive for greater efficiency and autonomy from political intrusion.

(7) Finally, it would be in the interest of the banking authorities and the USAID to learn more about various alternative

expansion paths traced out by the private banks in their penetration of agricultural markets. Each bank has chosen a particular operational style and has put together a particular mix of institutional links to reach selected producer clientele. It would be important to document how each bank has established and monitored creditworthiness criteria and has chosen its particular mix of agricultural clientele. These different portfolio patterns of growth could generate useful lessons for future portfolio expansion in agriculture.

NOTES

* Douglas H. Graham is Professor of Agricultural Economics at the Ohio State University. Research for this paper was sponsored by the Project on Policy Tools for rural Finance in Costa Rica, financed by the USAID Mission in San Jose, as part of the cooperative agreement between AID, Science and Technology Division, and the Ohio State University on Experimental Approaches to Rural Savings. The author assumes responsibility for the contents of the paper, which do not necessarily represent the views of AID.

1. See Rodrigo Chaves, "FEDECREDITO: Oportunidades y Peligros en la Evolución del Sistema de Cooperativas de Ahorro y Crédito," Rural Finance Program, Ohio State University, August, 1988.